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South Korea's Economy: Booming Again [redacted] 25X1

SUMMARY

Strong, across-the-board growth made 1986 one of the best years for the South Korean economy in the past 35, continuing an upward trend begun in the middle of 1985. South Korea's real GNP grew by 12.2 percent--in contrast to a relatively lackluster 5.4 percent in 1985. In addition, Seoul posted its first postwar trade surplus--$3.5 billion--which the government used to help reduce South Korea's $45 billion foreign debt. Although the near term looks bright, unfavorable trends in exchange rates, interest rates, or oil prices, as well as protectionist measures imposed by major trading partners, could cut into growth. [redacted] 25X1

Rebounding Exports Spur Growth

Strong 14-percent real GNP growth in the third quarter of 1986, brought South Korea's economy to 12.2-percent real growth last year in contrast to a relatively lackluster 5.4-percent GNP gain in 1985. This figure far exceeds the 8-percent real GNP

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growth targeted by Seoul for 1986, and our own forecast of 7-percent growth also proved to be too conservative. 25X1

This unexpectedly high growth stemmed largely from foreign trade aided by favorable foreign currency trends. A 26-percent increase in exports in 1986 gave Seoul its first postwar trade surplus. The turnaround is partly explained by a weaker dollar--to which the won is loosely tied--coupled with Seoul's aggressive devaluation of its currency in 1985--which bolstered the competitiveness of South Korean goods in most developed-country markets. For example, South Korea's sales to the United States and Europe increased 30 percent and 50 percent, respectively. At the same time, the impact of the strengthening yen on Japanese exports to these markets--the won has depreciated substantially against the yen in the past year--compounded the benefits of Seoul's currency policy 25X1

But foreign currency alignments explain only part of the increase in overseas trade. Seoul's exporters also have benefited from:

-- The introduction of new, big-ticket goods such as autos and electronics. Automobile sales increased 121 percent last year to $1.7 billion, and exports of electronics surged 56 percent to $6.7 billion, in part because of personal computer and VCR sales.

-- Strong growth in personal consumption by US consumers helped offset the usually negative impact of sluggish overall US economic growth on demand for Seoul's export mainstays, such as textiles. 25X1

On the other side of the current account ledger, imports grew only 12 percent in value terms, largely because falling oil prices shaved nearly $2 billion off the import bill. In addition, tumbling interest rates have reduced Seoul's debt servicing burden. Partially offsetting these gains were the cost of imports from Japan, which ballooned because of the strong yen. The rise in the value of the yen increased the cost of capital equipment and intermediate manufactured goods that Seoul receives from Japan. The foreign content of South Korea's exports is about one-third of their total value and Japan is the leading supplier of those inputs. South Korea's trade deficit with Japan was $5.4 billion last year. 25X1

The benefits of Seoul's booming export sector rippled through the economy:

-- Manufacturing output increased 16 percent last year, according to Bank of Korea estimates. Overall capacity utilization was about 84 percent, but the rate for export-oriented industries was a resource straining 90 percent.

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-- Real investment in machinery and equipment jumped by 21.5 percent last year, in contrast to an anemic 4.9-percent increase in 1985.

-- Non-farm unemployment stood at 3.6 percent in October, down from 4.9 percent in 1985. Seoul's estimates of unemployment, however, understate the actual figure--it is probably twice the reported rate. 25X1

Repairing the Economy's Cracks

On the basis of recent policy announcements, we believe South Korea's economic technocrats are using current economic successes to remove barriers that potentially could stifle future growth and to improve the welfare of South Korean workers--a heretofore neglected constituency. Recent initiatives include:

-- Foreign debt drawdown. Seoul reduced its foreign debt, the fourth largest among LDCs, by $1.5 billion last year and plans to whittle the debt down to $41.8 by the end of 1987 by paying off an additional net $2.7 billion. South Korea is restructuring its debt away from short-term credits, which make up about 20 percent of the total, and is liquidating expensive medium-term debt as well.

-- Closing the savings-investment gap. High interest rates for savings accounts, stable prices, and rising real wages helped push South Korea's savings rate to 33 percent of GNP, while rapidly increasing investment accounted for 30.2 percent of GNP--the first time domestic resources for investment have exceeded requirements.

-- Improving conglomerate balance sheets. Seoul is not relying solely on a booming economy to bolster the financial status of South Korea's debt-heavy conglomerates. Cross-investment by conglomerates is now controlled, and the government has restricted the share of new domestic and foreign credits flowing to the big firms to force them into the underdeveloped equity market. Economic technocrats have made this a priority because about half of GNP originates in the 30 largest firms and their bad debt has forced Seoul to make concessional loans to commercial banks, which are technically insolvent.

-- Reducing dependence on imports from Japan. Last year, Seoul announced an ambitious plan to boost domestic production of key intermediate and capital goods, a measure aimed primarily at Tokyo, according to the US

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Embassy and press reports. In addition, Seoul unveiled a five-year plan for reducing the trade imbalance with Japan. The plan ties the granting of import licenses for Japanese goods to a Korean firm's exports to Japan, limits trade financing for Japanese products, and encourages firms to diversify import sourcing to US companies in particular.

-- <u>Minimum wage, pension, and health insurance</u>. South Korea's Sixth Five-Year Plan (1987-91) includes provisions for a minimum wage to begin in 1988, but no wage has been set. Pension and health insurance benefits will be available to all workers by 1989, according to the plan. 25X1

Although the bull economy will help the government implement necessary reforms, the success of these programs is not ensured. For instance, Seoul has aborted attempts to limit the concentration of economic power in the conglomerates--most recently during 1985, when the slump forced the government to loosen credit controls. In addition, domestic and foreign bankers view small- and medium-sized firms as too risky. We are not convinced, moreover, that the minimum wage will be set high enough to swell the pay envelopes of a large number of workers or that the laws will be fairly implemented. 25X1

<u>Outlook</u>

South Korean economic planners are predicting 8-percent real GNP growth this year and a current account surplus of $5 billion. In our judgment, Seoul could surpass these goals. Particularly important will be the continued success of Korean exporters' diversification drive into new, fast growing products that must make up for the lack of growth in troubled industries, such as shipbuilding and overseas construction. 25X1

Seoul's upbeat growth and balance-of-payments scenarios are predicated on continued low oil prices and interest rates and a strong yen. These potentially volatile factors underscore how rapidly external shocks can change South Korea's fortunes; each dollar increase in oil prices boosts South Korea's imports by $200 million, and a percentage point increase in international interest rates inflates debt servicing by about $220 million. Other key external factors that will shape South Korea's growth path include:

-- <u>Economic growth in developed countries</u>. US economic performance will be a major determinant. The US market historically has taken over one-third of Seoul's sales abroad, and that dependency is increasing as South Korea looks to the United States to absorb new export items such as autos, semiconductors, and computers.

But many economists have lowered their projections of US economic gains in 1987, and Japan, South Korea's second-largest trading partner, also faces a lackluster economic outlook.

-- Protectionism. Developed country trading partners have used quotas and voluntary restraints to stem imports of South Korean textiles, apparel, and steel--which make up over one-third of South Korea's exports.

-- Security issues. A relatively heavy defense burden--about 5.5 percent of GNP--drags South Korea's economic growth and diverts scarce technical expertise from commercial endeavors.

-- Foreign debt. Although the level of debt is shrinking, it remains a key concern to Seoul. Notwithstanding this year's favorable balance-of-payments outlook, Seoul will require over $3 billion in foreign loans during 1987--$5.7 billion in repayments to foreign lenders less the $2.7 billion debt reduction, according to the US Embassy. Even this reduced debt level will pose political problems for the government, because Korea's dependence on foreign capital is a touchy issue. According to unscientific--but we believe indicative--polls, the average Korean considers foreign debt to be among the most worrisome issues. 25X1

Managing the domestic economy also will challenge Seoul's economic technocrats, but we believe there is little chance they will stumble. Nonetheless, the government will probably continue to have difficulty controlling the money supply--M2 grew 18 percent last year and is expected to increase 15 to 18 percent in 1987--in part because of the strength of the current account. In addition, fiscal stimulus--a budget deficit of 1.1 percent of GNP is expected this year--also will add to inflationary pressures. Economic tehnocrats believe that prices will rise this year, but at a modest 1 to 2 percent increase for wholesale prices, compared with a 1-percent drop in the wholesale price index last year. But some private forecasters in Korea expect up to 5-percent inflation in 1987, according to the press. 25X1

Implications for the United States

South Korea's continued recovery will have some benefits for US interests:

-- Favorable economic performance may muffle some of the grumbling from the average Korean and strident rhetoric from opposition elements concerning the government's efforts to accommodate Washington's market access demands.

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-- US interests may benefit from Seoul's efforts to diversify its import sources, particularly because the United States is being targeted as a source of raw materials, intermediate manufactured goods, and capital equipment.

-- A rapidly growing economy should be a plus for domestic stability leading up to the political succession in early 1988. But President Chun Doo Hwan remains unpopular and few credit him with fathering good economic results. If he fails to step down as he has pledged--his intentions are uncertain at this stage--or the succession is tainted by illegitimacy, political unrest is likely and the economy may falter as it did in 1979, when President Park was assassinated. 25X1

On balance, we believe trade tensions will continue to burden Washington-Seoul relations. Bilateral friction is bound to increase because important political stakes dominate the internal debate on many trade issues. In these cases rapid economic growth or the balance-of-payments situation will not be reason enough for Seoul to open its market to foreign products. The best example of a tough battle that lies ahead is the liberalization of agricultural imports. The farm and fisheries constituencies have lopsided weight in the political equation because rural districts are over-represented in the National Assembly and many urban Koreans have relatives back on the farm. In addition, South Koreans are intensely nationalistic and do not wish to be seen as buckling under to what the general population views as unwarranted flogging by Washington on trade issues. US policymakers, however will have additional leverage over Seoul in trade issues as South Korea's dependency on the US market for future growth increases. 25X1

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